The European Monetary System

European File

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Since the European Monetary System (EMS) came into operation on 13 March 1979, the countries of the European Community have had to face a second oil price shock, a sustained rise of the dollar and, since February 1985, a marked fall of the same currency. Despite these unsettled international conditions, the EMS has satisfactorily answered its first purpose. This was to establish close cooperation which would result in a zone of monetary and price stability in Europe.

This file first traces the historical context of the EMS and describes its genesis and objectives and how it works; it goes on to review the seven years during which the system has been functioning, and concludes with a a reflection on future prospects.[1]

The Treaty of Rome (1957), which founded the European Economic Community, made no provision for a European monetary zone. It confined itself to setting out certain principles for the coordination of internal monetary policies and for exchange rate policy, and set up a Monetary Committee with the task of formulating opinions on these matters. The creation in 1974 of the Committee of the Governors of the Central Banks complemented these arrangements by setting up a framework and a procedure for regular consultations among the central banks of the Community.

The fact that the Treaty has no specifically monetary aspect is hardly surprising, if one remembers the priorities of the Community at its inception (customs union, common agricultural market, competition rules, free circulation of persons, services and capital etc.) and the international monetary climate of the day, with a system of fixed exchange rates set up by the Bretton Woods agreements.

The success of the 'common market' and the interdependence which followed from it, as well as the 'growth in stability' of the world economy in the 1960s, helped foster the ambition to bring the countries of Europe still closer together, partially in the economic and monetary sphere.

From the 'snake' (1972-79) to the EMS

The Hague conference of Heads of State or Government of the European Community, held in December 1969, saw a commitment in principle and a new beginning. During that meeting the idea was launched of achieving, in stages, European economic and monetary union. The details of this union were spelled out in 1970, in the Werner Report (called after the chairman of the group of leaders, the head of the Luxembourg Government). In the monetary field, the union was to lead to:

- ☐ The institution of a single Community currency or at least the total convertibility of European currencies and irreversible fixing of their exchange rates;

[1] This file replaces our No 4/83.

- The transfer to Community level of various national competences in monetary and credit policy.

The first stage of this project began at the start of 1972. It consisted of restricting to ± 2.25% the margin of fluctuation between European currencies. The currencies would remain linked to the dollar, with a similar margin. This system gave rise to the image of the 'snake in the tunnel'. A European Monetary Cooperation Fund (EMCF) was set up, destined to be the embryo of a European central bank. To begin with, the EMCF had the task of managing the exchange mechanisms of the 'snake' and its various credit arrangements.

This first stage met with little success. The collapse of the Bretton Woods system, the energy crisis and the recession prevented its aims from being realized: there was not a sufficient political will to form a united front to cope with the difficulties. The 'snake' was first uncoupled from the floating dollar, then abandoned by several important member currencies. It wound up, against a general background of floating currencies, as a mere D-mark zone, comprised of the mark along with the currencies of the Benelux and Denmark.

It was from this abortive exercise that the European Monetary System took over in March 1979.

Genesis of the EMS

When the Bretton Woods system disintegrated in 1973, there were many who welcomed the advent of floating exchange rates. They believed that market forces would make for automatic adjustment of each country's external account: where there was a trade imbalance because of excessive export prices, depreciation of the national currency would follow, due to the fall in demand from foreign importers; this depreciation would boost exports and reduce imports, thus restoring the balance of external ttrade. An important consequence would be that floating exchange rates, by neutralizing the external constraint, would allow each country greater autonomy in the conduct of its general economic policy.

Events, however, did not live up to these expectations. There were many reasons: the increasing international division of labour, which has led to an ever more marked specialization of national economies, so that an exchange rate variation does not always have the anticipated mechanical effect on imports and exports; competitiveness, which is a matter not solely of price but also of quality and of meeting demand; the greater mobility of capital in search of profitable investment, which meant that capital flows became less and less a simple reflection of movements of merchandize. The floating of currencies, far from linking exchange rate trends coherently to fundamental trends in the economy, has encouraged erratic flows of capital. It has thus given rise to exchange rate movements unconnected with underlying economic realities, a phenomenon which has stimulated inflation and impeded growth.

At European level there was a gradual recognition of the risk and the cost of such an arrangement for the countries of the Community, economically integrated as they were: their trade with each other represented more than half of their total external trade.

The initiative for a European monetary revival based on the EMS was taken by Mr Roy Jenkins, then president of the European Commission, in a speech in Florence in October 1977. The subsequent negotiations spread over four European Councils, during which the Heads of State or Government of the Community made increasingly precise political commitments: they took the decision in principle in April 1978 and asked the European institutions to study the machinery for the System; in July of the same year, in Bremen, they agreed the broad lines; on 5 December 1978 they adopted the Brussels resolution, the charter of the EMS, on the basis of which were concluded agreements among the central banks who would organize the details of its application. Finally, on 12 March 1979, they gave the green light for the System to begin operating.

The purpose of the EMS

The aim of the System is to establish 'closer monetary cooperation leading to a zone of monetary stability in Europe'. This desire for stability applies first of all to exchange rates between Community currencies. However it does not end there. The stabilization being carried out is part of a wider strategy which also involves overcoming inflation, as the achievement of both external and internal stability is considered essential for a growth policy.

The EMS is a joint effort to overcome the constraints resulting from the *de facto* interdependence of European economies and is based on the parallel needs for exchange rate stabilization and for convergence of economic and monetary policies: the one supports the other.

If the EMS is therefore essentially economic in inspiration, it is still linked in some of its aspects to the longer-term aim of European monetary integration. That is what emerges particularly from the intention, expressed in the Brussels resolution, to consider the System being instituted as transitory and to consolidate its various elements two years later: there was to be a European Monetary Fund to take the place of the EMCF, as well as full use of the ECU as a reserve currency.

This objective is made clear in the Single Act modifying the Treaty of Rome which was signed in Luxembourg on 17 February 1986. It inserts into the Treaty an affirmation of the will to build an economic and monetary union and confirms the aim of the Community to make progress in the monetary field, relying mainly on the EMS and the ECU.

Components of the EMS and how the system works

The EMS is composed of three elements which complement each other: the ECU, the exchange rate mechanism and the financial solidarity mechanisms.

☐ *The ECU.* This is the central element of the system. It is a monetary unit, the value of which is calculated as a 'basket' of set amounts of each Community currency.[1] The ECU fulfills four functions, being used:

(i) for fixing the central rates in the exchange rate mechanism;

(ii) as the unit of reference for the divergence indicator of the same mechanism;

(iii) for denominating creditor and debtor balances resulting from the obligation to intervene in Community currencies;

(iv) as a reserve instrument and means of settlement among central banks in the EMS.

The first three functions will be discussed in the following section on the exchange rate mechanism. In its role as a reserve instrument, the ECU is issued by the European Monetary Cooperation Fund (EMCF) to the EMS central banks, in exchange for deposits by them of 20% of their gold reserves and 20% of their dollar reserves. The amount of ECU created as a result is adjusted every three months to take account of changes in the level of gold and dollar reserves and of variations in the ECU price of these assets. In July 1986, total ECU reserves were 43 000 million. These ECU can be used, within agreed limits, for settling the debts incurred by central banks in the operation of the EMS.

☐ *The exchange rate mechanism.* Each currency participating in the mechanism[2] has a central rate against the ECU. These central rates can be 'realigned' if necessary, by mutual agreement of the participating countries. From the ECU central rates are calculated bilateral central rates for each currency against each of the other participants. By allowing a margin of ± 2.25% to these bilateral central rates (± 6% for the lira), 'floor' and 'ceiling' rates are set: these are the limits within which central banks are obliged to maintain the currency by the means at their disposal, primarily by intervening in the money market in Community currencies. In practice this means selling the currency which has reached its ceiling rate and buying the one that is at its floor. When exchange

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[1] Made up according to the relative 'weights' of the different national economies, this basket is composed at the moment of 0.719 German marks, 0.0878 pounds sterling, 1.31 French francs, 140 lire, 0.256 guilders, 3.71 Belgian francs, 0.14 Luxembourg francs, 0.219 Danish crowns, 0.0087 Irish pounds and 1.15 drachmae. Note that the composition of the basket is reviewed every five years, and, in the event of a request, whenever the weight of a currency has changed by 25% or more. The peseta and escudo could be included in the ECU at the next five-yearly review in September 1989. 1 ECU = about £0.69, Ir.£0.76 or US$1.0 (at exchange rates current on 8 September 1986).

[2] Some member countries of the Community do not participate in the exchange rate mechanism: the United Kingdom, Greece, Spain and Portugal.

rates reach the limits, the obligation to intervene is unlimited. That is why support is provided through a mechanism for very short-term financing. A central bank that has to support its money by buying it with another EMS currency has unlimited credit to borrow that currency through the EMCF and are denominated in ECU. ECU reserves can be used for paying off the loans.

Apart from these exchange rate limits and the binding obligations they imply, the exchange rate mechanism has another component, known as the 'divergence indicator', which acts as an early-warning signal. This indicator is calculated for each currency on the basis of the maximum permitted gap between its market rate against the ECU and its central rate. When a currency crosses its divergence threshold, the country in question is supposed to take corrective measures. As it is a matter of action being presumed, the element of constraint is less than in the case of the exchange rate limits and need not involve intervention in the money market.

☐ *The credit mechanisms.* With the establishment of the EMS, three credit mechanisms created between 1970 and 1972 were strengthened in order to facilitate the operation of the exchange rate mechanism and help with financing for balance of payments deficits: [1]

- Very short-term financing. As already mentioned, its purpose is to finance obligatory intervention in Community currencies. Very short-term financing consists of an unlimited credit line which central banks participating in the exchange rate mechanism open to each other, in their own currencies. The amounts drawn are expressed in ECU and registered with the EMCF and carry interest. This financing is of very short duration (45 days after the end of the month) but it can be extended for three months subject to certain conditions and limits. With the consent of the creditors a second extension of three months can be obtained.

- Short-term monetary support. This is a system of mutual credit for all the central banks of the Community; it was increased in volume and in duration on the creation of the EMS. The amounts available under this heading at the moment come to more than 14 000 million ECU. The initial loan period is three months but it can be extended to a total duration of nine months.

- Medium-term financial assistance is a system of mutual credit which Member States can grant each other for two to five years. The credit available was increased when the EMS was set up and now stands at more than 11 000 million ECU.

[1] Also, from 1979 to the end of 1983, Ireland and Italy availed of temporary aid to less prosperous countries (interest rebates on Community loans) intended to strengthen their economic potential and thus assist the convergence of the various European economies.

The record to date

After a difficult beginning, the EMS today constitutes a valuable achievement in the process of building Europe, with positive effects for all to see. None the less, there are a number of shortcomings that cloud the picture.

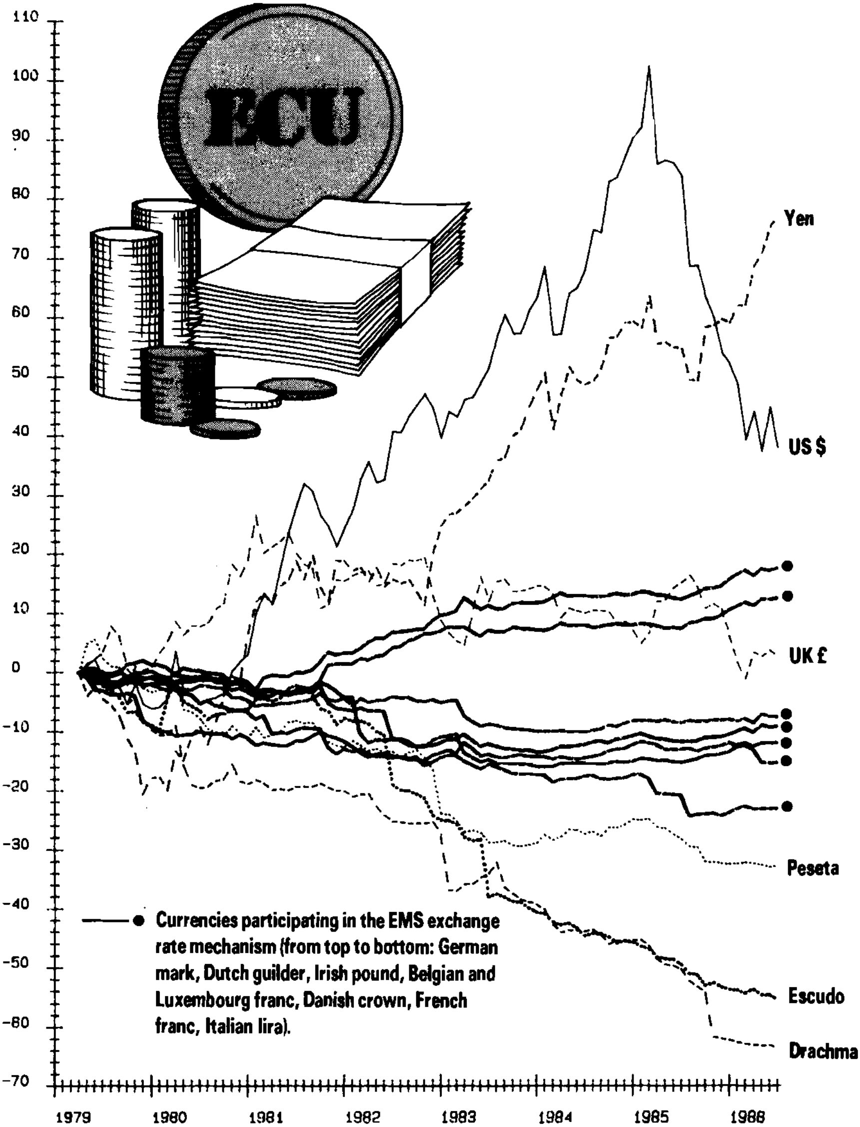
- The establishment of a zone of exchange rate stability is the most visibly positive effect of the EMS. Although the System began in particularly troubled monetary and economic circumstances (the rise of the dollar, the second oil crisis), so that its economic results varied at first, it has managed to work and to provide for realistic management of exchange rates. Despite seven realignments between March 1979 and March 1983, variations in exchange rates among European currencies have been much less than their fluctuations against other currencies (the difference is more than 50%). In addition, a consensus has gradually emerged on the need to aim at stabilization of prices. The result has been a greater convergence of economic policies, which explains why there have been only three monetary realignments since 1983 (July 1985, April and August 1986), of which two concerned only one EMS currency. Of course there are still divergences in interest rates among the currencies participating in the exchange rate mechanism, illustrating the need to continue on the road to convergence. Inflation rates have however been greatly reduced, falling on average for the participating countries from 12% in 1980 to 5% in 1985, with less than 4% anticipated in 1986. In the same period the average divergence from the lowest inflation rate has gone down from 6.2% to 2.8%. At the same time major efforts have been made to reduce public spending and governement deficits, particularly in Denmark, Belgium and France, making for lower real interest rates and improvements in current balances of payments.

  There is hardly any doubt that this favourable development is due in large measure to a deliberate and determined decision to make exchange rate stability a priority, or that the disciplines of the EMS have contributed to the necessary adjustments in economic policies. The ministerial meetings at which monetary 'realignments' are decided have gradually acquired a special importance: they are occasions for an examination in depth of the general economic situation and of the accompanying measures planned by the country that has taken the initiative in demanding a change in central rates.

- However, analysis of the working of the EMS also highlights some deficiencies. The purpose of the system is to group together all the Community's currencies; the non-participation of sterling in the exchange rate mechanism affects the functioning of EMS, particularly by impeding its internal development and reducing its attraction for third countries that might be interested in being associated with it. There is also the lira, which still avails of a 6% margin of fluctuation and is thus less-subject to the policy constraints that go with EMS membership. In addition, although the original idea was that intervention in support of a currency would happen when exchange rate limits were reached, in practice most interventions have taken place within those limits. The system

The European Monetary System, agent of exchange rate stability

Trend of European, American and Japanese currencies against the ECU



Source: Commission of the European Communities, DG II.

as originally conceived made no provision in this regard, for recourse to Community currencies, for access to very short-term financing, or for use of the ECU. As a result most of these interventions have been carried out in dollars, the divergence indicator has become less significant and the ECU has seen only limited use.

The improvements of 1985

The European Commission opened a debate in 1984 on the need to improve the working of the EMS. Following that discussion, a number of measures were adopted in June 1985. They related to:

- ☐ A certain relaxation of the rules for payment, allowing in certain cases the payment in ECU of more than 50% of a settlement under very short-term financing.

- ☐ An improvement in the return on the ECU. Previously this had been based on official bank rates. Now it is the weighted average of the money market rates for the component currencies. It is therefore a rate derived from market rates.

- ☐ The introduction of a mobilization mechanism. This allows a central bank in need of currency for intervention to raise ECU temporarily against dollars or Community currencies. These currencies are supplied by other member countries through the EMCF. The mechanism facilitates the financing of interventions when they take place within the fluctuation margins; this, as we have seen, has become normal practice.

- ☐ The widening of the official ECU circuit beyond the central banks of the Community. Central banks of third countries, as well as international monetary institutions, can ask for 'other holder' status with the EMCF. This enables them to acquire ECU on a temporary basis from banks within the EMS.

Private use of the ECU

There is one more positive and promising phenomenon to be mentioned: the increase in private use of the ECU. The existence and success of the EMS have encouraged commercial banks and other private operators to make steadily greater use of the ECU in Europe and elsewhere. As well as being used more for monetary and financial purposes (bond issues, bank deposits and credits, traveller's cheques etc.), the ECU has started to make a break-through in commerce as a currency for invoicing and payment. The rapid growth of the various segments of the private

[1] ECU allocated by the EMCF against deposits of gold and dollars do not attract interest, as their holders continue to earn a return on the assets on deposit. On the other hand, when a central bank uses ECU for payment of a debt, it pays interest to the bank which is receiving the transfer and thus accumulating ECU in excess of its original allocation.

market for the ECU has led to a substantial increase in ECU exchange transactions, both spot and forward. The ECU has developed into an instrument which, in its private uses, has the working characteristics of a currency (legal tender, a means of payment and of preserving assets) – at least in internationsal transactions. This development is reflected in the recognition of the ECU as a currency by the monetary authorities of the Community (with one exception at the moment) and of a growing number of third countries.

Prospects

Although there was nothing easy about the building of the EMS, its progress report is positive, both in terms of economic results – approximation of price trends, exchange rate stability – and in terms of its operating efficiency, where experience has made for improvements.

Thanks to the European Monetary System, as President Delors recalled when addressing the European Parliament recently, 'it has been possible to maintain an open trade system within the European Community'.

There is still a long way to go to economic and monetary union, the long-term objective confirmed by the revised Treaty. Progress towards that end will depend particularly on the completion of the big internal market, envisaged for 1992, in which goods, services and capital will circulate freely. The European Commission has made proposals in this regard and will continue to do so.

At the same time, as the EMS has become, in President Delors' words, the principal 'operational route for convergence', it is clear that its reinforcement will be essential for pressing forward with the building of Europe ■

Commission of the European Communities

Information offices (countries fully or partially English speaking*)

Ireland	39 Molesworth Street, Dublin 2 — Tel. 71 22 44
United Kingdom	8 Storey's Gate, London SW1P 3AT — Tel. 222 81 22 — 4 Cathedral Road, Cardiff CF1 9SG — Tel. 371631 — 7 Alva Street, Edinburgh EH2 4PH — Tel. 225 2058 — Windsor House, 9/15 Bedford Street, Belfast BT2 7EG — Tel. 40708
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Canada	Office Tower, Suite 1110, 350 Sparks Street, Ottawa Ont. KIR 7S8 — Tel. (613) 238 64 64
USA	2100 M Street, NW, Suite 707, Washington DC 20037 - USA — Tel. (202) 862-9500 — 245 East 47th Street, 1 Dag Hammarskjöld Plaza, New York, NY 10017 - USA — Tel. (212) 371-3804

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